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TAX ASPECTS OF DISCHARGE OF INDEBTEDNESS

by

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I. INTRODUCTION

A. The General Rule.

1. Gross income includes income from the discharge of indebtedness. § 61(a)(12)¹.
2. The principle that gross income includes gain or saving that is realized by a debtor upon the reduction or cancellation of outstanding indebtedness was established by the Supreme Court in U.S. v. Kirby Lumber Company, 284 U.S. 1 (1931). In that case, the taxpayer had purchased its own bonds at a discount in the open market. The Supreme Court found that as a result of the transaction the taxpayer "made available" assets previously offset by the liabilities that were now discharged. The Court found that the taxpayer had realized "an accession to income," taking those words in their "plain popular meaning"

¹ Unless otherwise indicated, statutory references are to the Internal Revenue Code of 1986. References to "regulations" are to Treasury Regulations.

3. As a general rule, a discharge of indebtedness creates income in an amount equal to the difference between the amount due on the debt and the amount, if any, paid for its discharge.
 - a. If an obligation has been issued at a discount or a premium, the amount of income must be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged. § 108(e)(3).
 - b. The statutory recharacterization provisions of the Internal Revenue Code must also be taken into account, principally §§ 1273 and 1274. In general, if these provisions apply, the amount of indebtedness for purposes of determining income from the discharge of indebtedness is the principal amount after application of these provisions to eliminate original issue discount and interest.
4. Discharge of indebtedness income is realized at the time the debt is repaid or acquired by the issuer or a related party. If the debt is not repaid or acquired by the debtor or a related party, the income is realized when it is clear that the debt will not be repaid. Cozzi v. Commissioner, 88 T.C. 435 (1987).

5. For the purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations, an outstanding debt acquired from an unrelated creditor by a party related to the debtor is treated as acquired by the debtor and, therefore, as income from the discharge of indebtedness. § 108(e)(4).
- a. Parties related to the debtor include a member of a controlled group of corporations of which the debtor is also a member, § 414(b); a trade or business under common control, § 414(c); a partner in a partnership controlled by the debtor or a controlled partnership, § 707(b)(1); or a family member or person related to the debtor, including a spouse of the debtor's child or grandchild. §§ 108(e)(4)(B) and 267(b).
 - b. The Secretary issued proposed Treas. Reg. §1.108-2 on March 21, 1991. The proposed regulation is somewhat controversial and is proposed to apply to any transaction covered by the proposed regulation on or after March 21, 1991.
 - c. Despite the absence of regulations, it is the position of the Internal Revenue Service that

§ 108(e)(4) is generally effective for any transaction after December 31, 1980, the effective date of the Bankruptcy Tax Act of 1980, which added § 108(e)(4) to the Internal Revenue Code.

6. The term "indebtedness of the taxpayer" means any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property. § 108(d)(1).
7. In the case of a partnership, the exclusion rules of § 108(a), including the determination of insolvency, any required reduction of tax attributes, and the special rules for discharge of qualified farm indebtedness are applied at the partner level. § 108(d)(6).
8. In the case of an S corporation, the exclusion rules of § 108(a), including the determination of insolvency, any required reduction of tax attributes, and the special rules for discharge of qualified farm indebtedness are applied at the corporate level. § 108(d)(7).
 - a. In the case of an S corporation, any loss or deduction which is suspended because the taxpayer did not have sufficient basis in his stock or debt is treated as a net operating

loss for the purposes of the reduction of tax attribute rules. § 108(d)(7)(B).

- b. A shareholder's adjusted basis in any indebtedness of an S corporation to the shareholder is determined without regard to any reduction in the basis of such indebtedness required by § 1367(b)(2). § 108(d)(7)(C). (Section 1367(b)(2) requires a reduction in the shareholder's basis in any indebtedness of the S corporation to the shareholder once that shareholder's basis in his stock has been reduced to zero.) The effect of the rule of § 108(d)(7)(C) is to prevent basis adjustments under § 1367(b)(2) from creating income from discharge of indebtedness when shareholder debt is contributed to the capital of an S corporation.

B. Distinctions From or Exceptions to the General Rule.

- 1. Gain on the disposition of property subject to debt distinguished.
 - a. Discharge of indebtedness income is ordinary income and may be eligible for exclusion from gross income under § 108.

- b. Gain on the sale or exchange of property subject to debt may be capital gain taxed at a lower rate than ordinary income.
- c. In the context of a sale or exchange of property subject to debt, income from discharge on indebtedness can only arise when the amount of recourse debt exceeds the fair market value of the property.

(1) If the property is subject to recourse debt and the amount of debt exceeds the fair market value of the property, the transaction is bifurcated. Gain from the sale or exchange of property arises to the extent that the fair market value of the property exceeds its basis and income from discharge of indebtedness arises to the extent the debt exceeds the fair market value of the property.

EXAMPLE: In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 (\$7,500 minus \$6,000). Reg. § 1.1001-2(c), Ex. 8.

(2) If the indebtedness discharged is nonrecourse, the entire amount of the nonrecourse indebtedness is included in the amount realized from the sale or exchange of property. There is no discharge of indebtedness income even if the amount of the nonrecourse debt exceeds the fair market value of the property. Tufts v. Commissioner, 461 U.S. 300 (1983). See Reg. § 1.1001-2(a)(2), which provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are income from the discharge of indebtedness under § 61(a)(12). There is no similar provision in the regulation excluding a nonrecourse liability from the amount realized on the sale or exchange of property.

2. Contingent Obligations Distinguished. A reduction in or discharge of a contingent debt obligation does not result in discharge of indebtedness income. Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner, 130 F.2d 141 (2d Cir. 1942).

3. Gifts or Bequests Distinguished.

- a. If the forgiveness of the indebtedness constitutes a gift from the creditor or is a bequest, the amount of the discharge of indebtedness is excluded from gross income as a gift or bequest. § 102.
- b. If the debt discharged is an installment obligation, cancellation by way of gift is treated as a disposition of the installment obligation otherwise than by sale or exchange. § 453B(f)(1). The obligation is treated as if it were paid at its fair market value which shall not be less than its face amount if the debtor and creditor are related persons. § 453B(f)(2).

4. The Reduction in Purchase Price Exception.

a. The judicial exception.

- (1) There are numerous cases holding that discharge of indebtedness does not result if the debtor negotiates a reduction in an indebtedness incurred as part of the purchase price of property and the value of the property has declined so that it is less than the amount of the debt. In that case, the discharge of indebtedness is treated as

a readjustment of the purchase price and the debtor's basis for the property is reduced to the extent of the discharge.

EXAMPLE: D owns property with a fair market value of \$80,000 subject to an indebtedness of \$100,000. If the indebtedness is reduced to \$80,000 there is no gross income to D and the basis of the property in his hands would be reduced by \$20,000.

(2) This judicially created reduction in purchase price exception is subject to several limitations:

(a) This exception will not apply if the current fair market value of the property is equal to or greater than the debt before it is reduced. This is true even if the value of the property has decreased since its acquisition and even if such decrease is greater than the amount of the debt discharged. Montgomery v. Commissioner, 65 T.C. 511 (1975).

(b) The discharge of indebtedness must result from face-to-face negotiations between the debtor and creditor with respect to the purchase price of the property. Fifth Avenue - Fourteenth Street

Corp. v. Commissioner, 147 F.2d
453 (2nd Cir. 1944).

- (c) The property must not have been sold or otherwise disposed of by the debtor.
- (3) The judicial exception applies only to reductions in debts secured by the property and either owed to the seller or assumed in the purchase of the property. Most of the cases hold that the exception does not apply to borrowings from third parties even though secured by the property. However, one case does hold that third party debt incurred to purchase the property qualifies for the exception. See, Nutter v. Commissioner, 7 T.C. 480 (1946).
- (4) If the reduction in purchase price exceeds the debtor's basis in the property, it appears that the debtor would realize discharge of indebtedness income to the extent that the reduction in debt exceeds the basis in property and that his basis would then be zero.

Otherwise, the debtor would have a negative basis in the property.

b. The statutory exception.

- (1) If the debt of a purchaser of property to the seller of the property which arose out of the purchase of the property is reduced, the reduction is treated as a purchase price adjustment. There is no discharge of indebtedness income. § 108(e)(5).
- (2) This exception does not apply if the reduction occurs in a bankruptcy or when the purchaser is insolvent. § 108(e)(5)(B).
- (3) Further, this exception will not apply if the seller has assigned the debt; if the debtor has transferred the purchased property; or if the debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation. H.R. Rep. No. 833, 96th Cong., 2d Sess. 16 (1980); S. Rep. No. 1035, 96th Cong., 2d Sess. 20 (1980).

- (4) There is no indication in the statute or in the Committee Reports that this exclusion is limited by the debtor's basis in the property.
- (5) A reduction in purchase price under § 108(e)(5) may result in recapture of investment credit. Although § 1017(c)(2) provides that a reduction in basis under that section is not treated as a disposition, § 1017 applies only to basis reductions required by §§ 108(b)(2)(D) and (b)(5). Further, at least one court has indicated that a reduction in purchase price would result in recapture of investment credit. Panhandle Eastern Pipeline Co. v. U.S., 654 F.2d 35 (Ct. Cl. 1981).
- (6) By its terms, § 108(e)(5) does not purport to repeal the judicially created reduction in purchase price exception, whereas § 108(e)(1) provides that the statutorily created insolvency exception (discussed below) repeals the earlier judicially created exception. Further, § 108(e)(5)(C) provides that the statutory exception will only apply

if "but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness" Therefore, it appears that the statutory exception does not replace the judicial exception and that the judicial exception remains available in bankruptcy and to insolvent taxpayers.

5. The "lost deduction" exception. There is no income from discharge of indebtedness to the extent that payment of the debt would have given rise to a deduction. § 108(e)(2).
6. The § 108(a) exceptions.
 - a. Debtors in bankruptcy.
 - (1) Gross income does not include any amount which would otherwise be includible by reason of the discharge (in whole or in part) of indebtedness if the discharge occurs in a Title 11 case.
 - (2) Note that the taxpayer need not be insolvent.
 - b. Insolvent taxpayers.
 - (1) Gross income does not include any amount which would otherwise be includible in gross income by reason of a discharge

- (in whole or in part) of indebtedness if the discharge occurs while the taxpayer is insolvent.
- (2) The insolvency exclusion cannot exceed the amount by which the taxpayer is insolvent. § 108(a)(3).
 - (3) "Insolvent" is defined in § 108(d)(3) as the excess of liabilities over the fair market value of assets as determined immediately before the discharge of indebtedness.
 - (4) The determination of the taxpayer's solvency is made without taking into account property that is exempt from creditors under state law. PLR 9125010. See, Marcus Estate v. Commissioner, T.C. Memo 1975-9.
 - (5) Further, the assets of a taxpayer's spouse are not required to be taken into account in determining the taxpayer's solvency even if a joint return is filed. PLR 8920019.
 - (6) The bankruptcy exclusion takes precedence over the insolvency exclusion. § 108(a)(2)(A).

c. Qualified farm indebtedness.

- (1) Gross income does not include any amount which would otherwise be includible in gross income by reason of the discharge (in whole or in part) of indebtedness if the indebtedness discharged is qualified farm indebtedness. § 108(a)(1)(C).
- (2) Special rules for the discharge of qualified farm indebtedness are contained in § 108(g).
- (3) In general, qualified farm indebtedness must be incurred directly in connection with the operation by the taxpayer of the trade or business of farming and 50% or more of the aggregate gross receipts of the taxpayer for the three taxable years preceding the taxable year in which the discharge of such indebtedness occurs must be attributable to the trade or business of farming. § 108(g)(2).
- (4) In general, the amount of qualified farm indebtedness excluded cannot exceed the sum of tax attributes and the aggregate adjusted bases of business and investment assets. § 108(g)(3).

- (5) Note that there is no insolvency requirement for the qualified farm indebtedness exception.
 - (6) The bankruptcy and insolvency exceptions take precedence over the qualified farm indebtedness exception. § 108(a)(2)(B).
- d. Any amount excluded from gross income under the bankruptcy, insolvency and qualified farm indebtedness exceptions must be applied to reduce the tax attributes of the taxpayer. § 108(b)(1). This is discussed in more detail in Section I.C. below.
7. The stock for debt exception.
- a. If a corporate debtor transfers stock to a creditor in satisfaction of its indebtedness, the corporation is treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. § 108(e)(10)(A). Thus, discharge of indebtedness income is realized to the extent that the amount of debt exceeds the value of the stock.
 - b. However, if the taxpayer is a debtor in a Title 11 case or to the extent that the taxpayer is insolvent, discharge of indebtedness income generally will not arise

in an exchange of stock for debt. The stock for debt exception, however, is limited.

- (1) To come within the exception, the taxpayer may not use "disqualified stock." Disqualified stock is any stock with a stated redemption price if
 - (a) it has a fixed redemption date,
 - (b) the issuer of the stock has the right to redeem it at one or more times, or
 - (c) the shareholder has the right to require its redemption at one or more times. § 108(e)(10)(B).
- (2) The stock for debt exception does not apply to the issuance of "nominal or token shares". § 108(e)(8)(A). Neither the statute nor the Committee Reports indicate what number of shares would be "nominal or token".
- (3) Further, the stock for debt exception does not apply with respect to an unsecured creditor where the ratio of the value of the stock received by such unsecured creditor to the amount of his indebtedness cancelled or exchanged for stock in a "workout" is less than 50% of

a similar ratio computed for all unsecured creditors participating in the workout. § 108(e)(8)(B). A "workout" includes a Title 11 case or other transaction or series of transactions involving a significant restructuring of the debt of the corporation in financial difficulty. S. Rep. No. 1035, 96th Cong., 2d Sess. 17.

- c. Apparently, the stock for debt exception applies even if the stock used is the stock of a successor corporation. See. S. Rep. No. 1035, 96th Cong., 2d Sess. 38.
 - d. If the § 108 stock for debt exception applies, there is no attribute reduction required.
8. The contribution to capital exception. Prior to the Bankruptcy Tax Act of 1980, if the shareholder contributed his debt to a corporation as a contribution to capital, there was no discharge of indebtedness income realized, even if the indebtedness represented a previously deducted amount. Putoma Corp. v. Commissioner, 601 F.2d 174 (5th Cir. 1979). After the Bankruptcy Tax Act of 1980, if the shareholder contributes the corporation's debt to it, the corporation is

treated as having satisfied the debt with an amount of money equal to the shareholder's adjusted basis in the debt. § 108(e)(6). The effect of § 108(e)(6) is to limit the contribution to capital exception to the extent of the shareholder's adjusted basis in the debt.

9. The student loan exception. In the case of an individual, gross income does not include any amount otherwise includible in gross income by reason of the discharge (in whole or in part) of any student loan if the discharge is pursuant to a provision of the loan under which all or part of the indebtedness would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers. § 108(f).
10. The exclusion from alternative minimum tax. Any amount excluded from gross income under § 108 or the corresponding provisions of prior law is not included in the computation of the preference for adjusted current earnings for alternative tax purposes. § 56(g)(4)(B)(i).

C. Attribute reduction.

1. If a taxpayer excludes discharge from indebtedness from gross income under the bankruptcy insolvency or qualified farm

indebtedness exceptions, it must reduce its tax attributes. § 108(b).

2. If attribute reduction is required under § 108(b), the taxpayer may elect under § 108(b)(5) to reduce the basis of depreciable property in the manner provided in § 1017.

a. The election may apply to any portion of the required reduction of tax attributes. § 108(b)(5)(A).

b. The amount to which the election applies may not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs. § 108(b)(5)(B).

3. If the taxpayer does not make a § 108(b)(5) election, tax attributes are reduced in the following order:

a. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

b. Any § 38 general business credit carryover to or from the taxable year of the discharge.

c. Any net capital loss for the taxable year of the discharge and any capital loss carryover to such taxable year.

- d. Basis under the rules provided by § 1017.
 - e. Any foreign tax credit carryover to or from the taxable year of the discharge.
4. The reduction of tax attributes is made on a dollar for dollar basis except that credit carryovers are reduced 33-1/3 cents for each dollar excluded from income under § 108(a). § 108(b)(3).
 5. The reduction of tax attributes is made after the determination of tax for the taxable year of the discharge. Further, net operating losses and capital losses arising in the year of the discharge are reduced before net operating loss and capital loss carryovers. Finally, carryovers are reduced in the order of the taxable years in which the carryovers arose. § 108(b)(4).
 6. If the taxpayer elects to reduce the basis of depreciable property under § 108(b)(5) or if basis reduction is required as step 4 in the reduction of tax attributes required by § 108(b), the rules for doing so are provided in § 1017.
 - a. Basis reduction applies only to property held at the beginning of the taxable year following the taxable year in which the discharge occurs. § 1017(a).

- b. No reduction is made in the basis of property which is exempt under § 522 of the Bankruptcy Code. § 1017(c).
- c. The particular properties and amount by which bases of assets are to be reduced will be determined under regulations to be issued. § 1017(b)(1).
 - (1) The legislative history of § 108 indicates that the order of reduction in the regulations for bankruptcy cases will generally be in accord with the bases reduction regulations presently issued under § 1016.
 - (2) Reg. §§ 1.1017-1 and -2 contain the ordering rules for reducing bases of depreciable assets for solvent debtors outside bankruptcy. The basis reduction election for solvent debtors outside bankruptcy was repealed by the Tax Reform Act of 1986. It is not clear whether the regulations issued under § 1017 will become the model for reducing basis in the case of insolvent debtors outside bankruptcy.
- d. In the case of bankrupt or insolvent debtors, basis reductions may not exceed the

excess of the aggregate of the basis of the property held by the taxpayer over the aggregate of the liabilities of the taxpayer, both determined immediately after the discharge of indebtedness. This limitation does not apply to a reduction in basis by reason of an election under § 108(b)(5). § 1017(b)(2).

7. For the purposes of § 1017, the term "depreciable property" means any property of character subject to the allowance for depreciation but only if the basis reduction will reduce the amount of depreciation or amortization otherwise allowable for the period immediately following such reduction.
8. The interest of a partner in a partnership is treated as depreciable property to the extent of the partner's proportionate share of the depreciable property of the partnership but only if there is a corresponding reduction in the partnership's basis in the depreciable property with respect to such partner.
9. A reduction in basis under § 1017 is not treated as a disposition of the property. § 1017(c)(2). Thus, there is no recapture of investment credit as a result of the reduction in basis and,

presumably, there is no recapture of depreciation under §§ 1245 and 1250.

10. If property whose basis has been reduced under § 1017 is disposed of at a gain, any portion of the gain realized which is attributable to the basis reduction will be ordinary income. § 1017(d). The statute achieves this effect by treating the reduction in basis as a deduction allowed for depreciation and by treating property which is neither § 1245 nor § 1250 property as if it were § 1245 property.

II. EXAMPLES.²

Marvana Corporation has fallen on hard times. Its junk bond debt greatly exceeds the value of its assets. Its creditors are restless. The following examples illustrate the tax results of various Marvana initiatives after the enactment of the Revenue Reconciliation Act of 1990 ("RRA 90").

A. Example 1. Marvana exchanges \$1,000 face amount, zero coupon New Debt (fair market value ("f.m.v.") \$300). due in 7 years for an Investor's outstanding \$1,000 Old Debt (adjusted issue price \$1,000).

1. Under § 108(e)(11), Marvana's discharge of indebtedness income from a debt-for-debt exchange

² Examples in this Section are used with the permission of Robert A. Jacobs of Milbank, Tweed, Hadley & McCloy, New York, New York.

is determined by treating the Old Debt as if it were satisfied for cash equal to the issue price of the New Debt. Issue price is determined under §§1273 and 1274. § 108(e)(11)(B).

2. If either the New Debt or Old Debt is traded on an established securities market ("publicly traded"), the New Debt issue price is the traded price, i.e., its f.m.v. § 1273(b)(3); Prop. Reg. § 1.1273-2(c). If neither the New Debt nor the Old Debt is publicly traded, the New Debt issue price is its stated principal amount, provided the New Debt has adequate stated interest. Because the New Debt has no stated interest, the New Debt issue price is the present value of the New Debt payments determined by using the applicable federate rate ("AFR"). § 1274. If the AFR equals 8%, the New Debt issue price will be \$583.
3. The \$417 difference between the \$583 issue price of the New Debt and the \$1,000 adjusted issue price of the Old Debt is discharge of indebtedness income to Marvana. § 108(e)(11).
4. If either the Old Debt or New Debt is publicly traded, the issue price will be \$300 (f.m.v.). The \$700 difference between the \$300 issue price of the New Debt and the \$1,000 adjusted issue

price of the Old Debt is discharge of indebtedness income to Marvana. § 108(e)(11).

5. Under § 108(a), the discharge of indebtedness income will be excluded if Marvana is in a Title 11 proceeding, or to the extent Marvana is insolvent. Discharge of indebtedness income excluded under § 108(a) will reduce tax attributes, including NOLs, tax credits and asset bases, in the manner prescribed by § 108(b).
6. Discharge of indebtedness income excluded under § 108(a) is excluded from alternative minimum taxable income ("AMTI"), the base upon which the alternative minimum tax ("AMT") is computed. Although discharge of indebtedness income excluded under § 108(a) generally increases earnings and profits ("E&P"), the E&P adjustments required when computing the adjusted current earnings ("ACE") adjustment to AMTI do not include discharge of indebtedness income excluded under § 108(a). § 56(g)-1(c)(4).
7. If Marvana is solvent and not in Title 11, the recognized discharge of indebtedness income may be offset by available Marvana NOLs. Even if Marvana has sufficient NOLs to offset all the discharge of indebtedness income, it may be subject to AMT, because alternative minimum tax NOLs ("AMT NOLs"),

can only reduce AMTI to the extent of 90% of the loss company's AMTI determined before the AMT NOL deduction. § 53(d)(1)(A).

8. If Marvana does not have adequate NOLs to shelter its discharge of indebtedness income and is not insolvent, Marvana may file a Title 11 petition to secure the § 108(a) discharge of indebtedness exclusion benefits.
9. The \$700 difference between the \$300 issue price of the New Debt and its \$1,000 stated redemption price at maturity is original issue discount ("OID"). § 1273(a)(1). That OID is deductible by Marvana on a constant interest rate basis over the 7 year term of the New Debt. § 1272(a); Prop. Reg. § 1.1271-1(b).
10. Because the yield on a 7-year note with an issue price of \$300 and a principal amount of \$1,000 is over 18%, the New Debt will be subject to the § 163(e)(5) rules applicable to high yield discount obligations. Under those rules, if the New Debt yield equals or exceeds the sum of the AFR plus 5 percentage points, Marvana may not accrue OID on the New Debt until it is paid. To the extent the yield exceeds the sum of the AFR plus 6 percentage points, the interest will be disallowed. Id.

11. Marvana's Investor exchanging its Old Debt for New Debt recognizes no gain or loss on the exchange. §§ 368(a)(1)(E); 354. Investor substitutes its \$1,000 basis in its Old Debt as its New Debt basis. § 358. Each year, Investor includes in income, on an economic accrual basis, OID totalling \$700 over 7 years. § 1272(a). Investor increases its \$1,000 basis in the New Debt each year by the amount of OID included in gross income. Prop. Reg. § 1.1271-1(j). But see Prop. Reg. § 1.1271-1(a)(2)(i), excluding from § 1272 OID treatment a holder of debt issued at a discount where the holder has "purchased" the debt instrument at a premium. Query, has Investor "purchased" the New Debt? Possible application of Associated Patentees v. Commissioner, 4 T.C. 979 (1945) principles here would avoid the harsh, illogical results of adding OID income to Investor's basis, creating bond premium.

B. Example 2. Marvana exchanges \$300 face amount New Debt (f.m.v. \$300) due in 7 years for outstanding \$1,000 Old Debt.

1. The \$700 difference between \$300 issue price of New Debt and \$1,000 Old Debt is discharge of indebtedness income to Marvana.

2. Code § 108(a) will exclude the discharge of indebtedness income if Marvana is in a Title 11 proceeding, or to the extent Marvana is insolvent. Marvana's favorable tax attributes would be reduced.
3. No AMTI or ACE inclusion to the extent discharge of indebtedness income is excluded under § 108(a). § 56(g)(4)(B); Prop. Reg. § 1.56(g)-1(c)(4).
4. If Marvana is solvent and not in Title 11, Marvana's NOLs will reduce the discharge of indebtedness income. Marvana's use of its AMT NOLs to reduce AMTI resulting from recognition of discharge of indebtedness income will be subject to the limitations of § 56(d)(1)(A).
5. If Marvana does not have adequate NOLs to shelter its discharge of indebtedness income and is not insolvent, Marvana may file a Title 11 petition to secure the discharge of indebtedness exclusion of § 108(a).
6. No OID. The issue price of the New Debt is equal to its face amount.
7. Marvana's Investor recognizes no gain or loss on the exchange of Old Debt for New Debt. §§ 368(a)(1)(E) and 354. Investor substitutes its \$1,000 as his Old Debt as its New Debt basis. § 358.

C. Example 3. Marvana has Old Debt of \$1,000, adjusted issue price \$1,000. Marvana has a tax basis in its assets of \$300 and NOLs of \$200. Pursuant to a bankruptcy reorganization plan, Marvana's creditors receive, in exchange for their Old Debt, New Debt with an issue price of \$583 as determined under § 1274 (assuming an 8% AFR). Neither the Old Debt nor the New Debt is publicly traded, but the f.m.v. of the New Debt is \$300.

1. The \$417 difference between the \$583 issue price of the New Debt and the \$1,000 adjusted issue price of the Old Debt is discharge of indebtedness income. § 108(e)(11).
2. Code § 108(a) excludes the discharge of indebtedness income because Marvana is in Title 11. Under the § 108(b) attribute reduction rules, Marvana must reduce its NOLs to zero. Marvana's bases in its assets would normally then be reduced. Under § 1017(b)(2), asset bases will not be reduced because the amount of remaining debt (\$583)³ exceeds the asset basis (\$300). Accordingly, \$217 of discharge of indebtedness

³ This calculation assumes "the aggregate ... liabilities" of the taxpayer described in Code § 1017(b)(2)(B) means adjusted issue price, rather than face or fair market value.

income does not reduce any tax attribute, and is thus never effectively taxed.

D. Example 4. In exchange for its \$1,000 Old Debt, Marvana issues New Preferred Stock with a \$300 redemption value and a \$300 f.m.v.

1. Marvana is issuing solely stock for Old Debt. The New Preferred Stock is "disqualified stock," defined by § 108(e)(10)(B)(ii) as -- Any stock with a stated redemption price if --
 - a. the stock has a fixed redemption date; or
 - b. the issuer has the right to call the stock at one or more times; or
 - c. the holders have the right to put the stock to the issuer at one or more times.

The disqualified stock does not qualify for the "stock-for-debt" exception to discharge of indebtedness. § 108(e)(10)(B).

2. The difference between the \$300 f.m.v. of the disqualified stock and the \$1,000 adjusted issue price of the Old Debt yields \$700 discharge of indebtedness income. § 108(e)(10)(A).
3. Code § 108(a) excludes the discharge of indebtedness income if Marvana is in Title 11, or to the extent Marvana is insolvent. Marvana's favorable tax attributes would be reduced under § 108(b).

4. Marvana's discharge of indebtedness income excluded under § 108(a) is not included in Marvana's AMTI or ACE base. § 56(g)(4)(B); Prop. Reg. § 1.56(g)-1(c)(4).
 5. If Marvana is solvent and not in Title 11, Marvana's NOLs will reduce its taxable discharge of indebtedness income, although Marvana's use of its AMT NOLs to reduce AMTI resulting from recognition of discharge of indebtedness income will be subject to the § 56(d)(1)(A) limitations.
 6. If Marvana does not have adequate NOLs to shelter its discharge of indebtedness income and is not insolvent, Marvana may file a Title 11 petition to secure the § 108(a) discharge of indebtedness exclusion benefits.
 7. Investor substitutes its \$1,000 Old Debt basis as its basis in the New Preferred Stock.
- E. Example 5. In exchange for its \$1,000 Old Debt held by Investor, Marvana issues New Preferred Stock with a \$300 redemption value and \$300 f.m.v.; and Common Stock worth \$10.
1. Marvana's disqualified New Preferred Stock does not qualify for the stock-for-debt exception to discharge of indebtedness.
 2. Under § 108(e)(8) the Common Stock is not treated as stock qualifying for the stock for debt

exception. As the \$10 of Common Stock represents only slightly more than three percent of the total consideration ($10 \div 310$ or 3.23%) and less than 01.5 percent of the debt it is deemed to satisfy, the Common Stock is "nominal or token."

3. The New Preferred Stock would be treated as satisfying debt equal to its f.m.v. (\$300) and the Common Stock would be treated as satisfying the remaining debt (\$700). The exchange would generate \$690 of discharge of indebtedness income under § 108(e)(10)(A).
4. The discharge of indebtedness income would be excluded under § 108(a) if Marvana is in Title 11 or to the extent Marvana is insolvent. Marvana's favorable tax attributes would be reduced.
5. Marvana's discharge of indebtedness income excluded under § 108(a) will not be included in Marvana's AMTI or ACE base. Prop. Reg. § 1.56(g)-1(C)(4).
6. If Marvana is solvent and not in Title 11, Marvana's NOLs will reduce discharge of indebtedness income, although Marvana's use of its AMT NOLs to reduce AMTI from discharge of indebtedness will be subject to the § 56(d)(1)(A) limitations.

7. If Marvana's does not have adequate NOLs to shelter its discharge of indebtedness income and is not insolvent, it may file a Title 11 petition to secure the § 108(a) discharge of indebtedness exclusion benefits.